DEDUCTIONS FOR REFUNDED CLAIM OF RIGHT INCOME: SECTION 1341 AND DEPLETION ALLOWANCES

In 1952 the Skelly Oil Company was producing and selling natural gas in Oklahoma, under contract, to the Cities Service Company and the Dorchester Corporation. In that year, the Oklahoma Corporation Commission established a minimum price for sales of natural gas, thus raising the price stated in the previous contracts. However, in 1958 the United States Supreme Court ruled that the minimum price order was invalid and it was subsequently vacated.[1] During the years 1952 through 1957, Skelly had included the amounts received under the minimum price order in its "gross income from the property,"[2] and thus received a 27½% depletion allowance for that income.[3]

In 1958, Skelly was forced to repay the overcharge of $5,536.54 to the Dorchester Corporation, and settled a lawsuit brought by the Cities Service Company by paying them $500,000. On its 1958 Federal tax return, Skelly took a business expense deduction for the full $505,536.54 which it had returned to its customers. The Internal Revenue Service, however, objected and reduced Skelly's 1958 depletion allowance by $139,022.55, which represented 27½% of the amount deducted on the return. Skelly paid the deficiency adjustment, filed a claim and ultimately filed a suit for a refund. The District Court upheld the adjustment,[4] but the Court of Appeals *reversed.*[5] Upon petition by the government, the Supreme Court granted certiorari,[6] and *reversed,*[7] holding that Section 1341 of the Internal Revenue Code does not permit the taxpayer to deduct the total refunded amount without subtracting the amount taken previously as a depletion.

I. General Background

In order to fully understand the problems which arose in the noted case, it is first necessary to briefly consider some of the general concepts of tax law as set forth in several Supreme Court decisions. One of the most basic concepts is that each year's tax must be definitely determined on the

[1] Michigan Wisconsin Pipeline Co. v. Corp. Comm'm. of Oklahoma, 355 U.S. 425 (1958).

[2] "Gross income from the property," in the case of oil and gas wells, refers to the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. "Gross income from the property" is a component of "gross income."

[3] A percentage depletion is allowed at a rate of 27½% of the "gross income from the property" subject to the limitation that it may not exceed 50% of the "taxable income from the property." INT. REV. CODE of 1954, §§ 612, 613(a), 613(b).

[4] Skelly Oil Co. v. United States, 255 F. Supp. 228 (N.D. Okla. 1966).

[5] Skelly Oil Co. v. United States, 392 F.2d 128 (10th Cir. 1967), *aff'd. on rehearing* 392 F.2d 133 (1968).

[6] Skelly Oil Co. v. United States, 393 U.S. 820 (1968).

[7] Skelly Oil Co. v. United States, 394 U.S. 678 (1969).

basis of a calendar or fiscal year. This doctrine was adopted in 1931 by the Supreme Court in *Burnet v. Sanford & Brooks Co.*[8] Under this approach, taxable income is computed on the basis of the income and expenses which represent all of the transactions during a twelve month period, including transactions that have not been fully completed within that period. This approach was chosen as preferrable to a transactional accounting system, whereby the income from each transaction is determined only upon completion of the transaction and therefore not reported until the year of completion. Thus the assessment of the tax might be postponed "[u]ntil the end of a lifetime, or for some other indefinite period. . . ."[9] It was in *Burnet* that the Supreme Court decided that the annual approach was more desirable because of its comparably uncomplicated application, and because it provided a source of ascertainable revenue to the government at regular intervals.

To compliment the annual accounting approach the Supreme Court announced one year later the well-known "Claim of Right" doctrine in the case of *North American Oil Consolidated v. Burnet.*[10] This logical corollary of the annual system was stated by Justice Brandeis as follows:

> If a taxpayer received earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[11]

Thus, if a taxpayer receives income in a taxable year, he is required to report it as income for that year even though his claim of right to it is contingent or in doubt, and even though it may develop later that he was not entitled to it.[12] This doctrine is justified on the grounds that the government cannot await the final outcome of all possible contingencies before collecting its revenue, and therefore the taxpayer must report his income as it currently stands.

Although the issues in the *North American Oil* case were settled at this point,[13] the Court went on to explain the procedure to be followed if the taxpayer was required to return the income in a later year:

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8 282 U.S. 359 (1931). The Court stated at 365:

> "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."

9 *Id.* The Court went on to hold that a taxpayer could not postpone payment of a tax until it was finally determined whether or not the uncompleted transaction would actually produce an income gain.

10 286 U.S. 417 (1932).

11 *Id.* at 424.

12 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.103 (rev. ed. 1967).

13 The income from oil land had been collected in 1916 by a court-appointed receiver. In 1917 the owner won the suit and the income was paid over to him. The suit was appealed how-

> If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year.[14]

This remedial procedure set out by Brandeis was in complete agreement with the annual accounting system in that it required a deduction to be taken during the current taxable year, i.e., the year of the return, rather than giving the taxpayer a refund for the year of receipt. However, a defect that was inherent in the rule forced some individual taxpayers to disagree with its strict application in certain situations. The difficulty arose in cases where the taxpayer found himself in a lower tax bracket or where tax rates had been reduced since the year he reported the claim of right income. In such a situation the taxpayer paid more taxes in the year of receipt than the benefit he received from the deduction in the year of return.

In view of the obvious harshness of such a result, some lower courts chose to ignore the remedial dictum in *North American Oil* and treated the income as being reported because of a "mistake of fact,"[15] and consequently the taxpayer was entitled to a refund for the year of receipt.[16] The courts that allowed this type of remedy distinguished the *North American Oil* case on the ground that the taxpayer there had asked the government to defer collecting the tax until the litigation had solved the issue, whereas in these cases the tax had already been paid.

In effect, however, these decisions were merely a guise for utilizing the old transactional approach, which the Supreme Court had specifically rejected in the *Sanford & Brooks Co.* case. By this time the proponents of the transactional method had accepted the idea of reporting claim of right income in the year of receipt, but they felt that once the contingencies were finally settled, and the return of income was required, then the only equitable way to remedy the situation was to treat the entire occurrence within one transaction. Under this approach, the taxpayer would then receive a refund based on a recomputation of the taxes during the year of receipt, rather than giving him a deduction for the year of return.

It was precisely this type of recomputation that the Supreme Court had anticipated by its dictum in *North American Oil*, for they foresaw that it would be attempted even though it would disrupt the accounting year. Thus, when the Court of Claims utilized this transactional remedy in *United States* v. *Lewis*,[17] the Supreme Court emphatically reversed,[18] re-

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ever, and finally affirmed in 1922. The issue in North American Oil then was whether the income should have been reported in 1916, 1917, or 1922.

[14] North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932).

[15] Greenwald v. United States, 57 F. Supp. 569 (Ct. Cl. 1944); Gargaro v. United States, 73 F. Supp. 973 (Ct. Cl. 1947).

[16] Some courts followed the rule strictly. *See* Haberkorn v. United States, 173 F.2d 587 (6th Cir. 1949).

[17] 91 F. Supp. 1017 (Ct. Cl. 1950).

[18] 340 U.S. 590 (1951).

peating the words of *North American Oil* and pointing out that "[n]othing in this language permits an exception merely because a taxpayer is 'mistaken' as to the validity of his claim."[19] The Court then went on to reaffirm its belief that the rule had to be strictly enforced:

> Income taxes must be paid on income received (or accrued) during an annual accounting period. . . . The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. . . . We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.[20]

The Court therefore felt that, although it would be harsh at times, the rule was a necessary by-product of accounting year. It also should be pointed out that the rule sometimes benefitted the taxpayer if, for example, the tax rates had increased since the year of receipt. Furthermore, the Court pointed out that the three-year statute of limitations would preclude recovery in many cases if the transactional remedy was used.[21]

Despite the clear intent of the Supreme Court, many lower courts continued to search for a more equitable remedy in these cases. In *Healy* v. *Commissioner*,[22] the Tax Court held that the income was received by the taxpayer as a constructive trustee for the benefit of the creditors of the corporation and thus was not income to the individual trustee for he ". . . received nothing . . . for his separate use and benefit. . . ."[23]

The Supreme Court once again was forced to restate its opinion on such attempts to undermine the accounting system:[24]

> Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a

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[19] *Id.* at 591.

[20] *Id.* at 592; Justice Douglas vigorously dissented:
"Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that the payment was made on money which was not income to the taxpayer."

[21] *Id.* at 592, n.1.

[22] 16 T.C. 200 (1951).

[23] Eisner v. Macomber, 252 U.S. 189, 211 (1920).

[24] Healy v. Commissioner, 345 U.S. 278 (1953). At 282-83 the Court stated:
"A constructive trust is a fiction imposed as an equitable device for achieving justice. . . . Even though it has a retroactive existence in legal fiction, fiction cannot change the "readily realizable economic value" and practical "use and benefit" which these taxpayers enjoyed during a prior annual accounting period, antecedent to the declaration of the constructive trust."

taxpayer or to the government in a particular case that a different rule be followed.[25]

II. The Enactment of § 1341

It was in this atmosphere that Congress finally stepped in and provided a workable and equitable remedy to the problem by enacting Section 1341 of the Internal Revenue Code of 1954.[26] Congress had no intention of tampering with the claim of right doctrine as such, but rather was dealing solely with the remedial procedure to be followed after claim of right income had to be returned by the taxpayer. In short, the sole purpose of Section 1341 was to remedy the inequitable results reached in cases like *Healy* and *Lewis*.[27]

Section 1341 requires that three conditions be met before it will apply. First, it is necessary that the taxpayer show that he received an item of income under a claim of right in a prior year and that he reported that item in his gross income for that year. Secondly, he must show that he is now entitled to a deduction because of a final determination that he did not have an unrestricted right to that item. Lastly, the amount of the deduction must exceed $3000. Once these conditions are met, the tax for the year of return will be the lesser of two computations. One computation ((a)(4)) is arrived at by using the method applied in *Healy* and *Lewis*, *i.e.*, the tax for the current year calculated with the deduction. The other computation ((a)(5)) is arrived at by reducing the tax for the current year (without the deduction) by an amount equal to the decrease in tax for the prior year which results solely from the exclusion of the item from the gross income. In other words, the taxpayer subtracts the excess amount of tax he paid in the prior year from this year's tax.

Thus, if tax rates have been lowered since the year of receipt, an (a)(5)

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[25] *Id.* at 284-85.

[26] Section 1341 (a) provides:

"If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and (3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)." Int. Rev. Code of 1954, § 1341(a).

[27] S. Rep. No. 1622, 83d Cong., 2d Sess. 118; H. Rep. No. 1337, 83d Cong., 2d Sess. 86 (1954).

In many instances of this nature the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

computation would be the lesser, and therefore, the applicable tax. On the other hand, if tax rates have gone up, an (a)(4) computation would be the tax for the current year. It is important to note that if the latter occurs, the taxpayer receives a greater tax benefit for the current year than the detriment he suffered in the prior year. Therefore, the intent of Congress was to make sure that the taxpayer got at least an equal amount of taxes back in the year of return, while also recognizing that he might get back an even greater amount.

A closer analysis of Section 1341 reveals how Congress, in effect, compromised between the annual and transactional approaches. The (a)(4) computation represents the strict annual approach since it merely codified the old law as applied by the Supreme Court in *Healy* and *Lewis*.[28] Congress made sure that this approach would be used in the bulk of cases since it is applicable also in situations where the tax brackets and rates have remained unchanged,[29] and also in cases where the amount is less than $3000.[30] On the other hand, the (a)(5) computation represents a combination of both the annual and transactional methods. It resembles the latter in that it is a recomputation of the prior year's tax which is expressly prohibited by the annual method. However, (a)(5) provides for a current year adjustment rather than a refund for the prior year as the transactionalist would demand. Thus, § 1341 introduces a new approach in (a)(5) which might be called a modified transactional method, while at the same time it retains the old annual method in (a)(4).

It was under Section 1341 (a)(4) that Skelly Oil took a deduction for the amount of repayments on its 1958 tax return since its tax bracket and tax rates remained unchanged.[31] The obvious problem that arose was whether Skelly could deduct the full amount of repayments without subtracting the amount of depletion taken on that figure when it was reported originally as income. At first glance the obvious answer is that Skelly should have adjusted its 1958 deduction to accurately reflect the depletion allowance given in the years of receipt. Otherwise, Skelly will receive a tax benefit in the year of return that exceeds the tax detriment incurred by the amount of the depletion allowance of 27½%. In other words, Skelly will get back $1.275 for every $1.00 it paid in taxes. On the other hand,

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[28] Skelly Oil Co. v. United States, 394 U.S. 678, 682 (1969).
"When the new approach was not advantageous to the taxpayer, the old law was to apply under § 1341 (a)(4)."

[29] *Id.*

[30] S. REP. No. 1622, 83 Cong., 2d Sess. 118; H. REP. No. 1337, 83d Cong., 2d Sess. 87 (1954).
"Moreover, with amounts of $3,000 or under, the effect of excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution."

[31] Skelly Oil Co. v. United States, 392 F.2d 128, 131 (1968).

in view of the complicated background which led up to the enactment of § 1341, a contrary answer is not altogether unfounded.

III. Arguments Based on Section 1341

Since the Supreme Court opinion neglects to state both sides of the argument fully and clearly, this note will attempt to do so. The argument can be divided into two major categories; the statutory argument, and the case-law argument. The statutory argument is based on an interpretation of Section 1341 itself. This includes the controversy over the meaning of the word "deduction" as used in that section. There is also disagreement as to whether the deduction must be adjusted by referring to other sections of the Code. Related to this problem is the double deduction argument. Finally, there is a general discussion of what Congress actually intended when it enacted Section 1341. The latter is a major argument, concerning itself with general intent and is therefore quite different from the frequent discussions of more specific intent in relation to the other statutory arguments.

The pre-§ 1341 argument concerns itself with the application of the general case-law concepts discussed earlier and, in addition, an analysis of several cases which more specifically relate to the issues in the noted case, *i.e.*, the definition of the word "deduction," and the need for adjustments.

A. Definition of "Deduction" Under Section 1341

The statutory argument centers mainly on the interpretation of the words "item" and "deduction" found in (a)(1) and (a)(2) as follows:

> If—
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item;

The problem, in short, is to determine what exactly is meant by the "deduction" as used in (a)(2). Is it the equivalent of the "item" in (a)(1), or is it an amount that might or might not be equal to that item, depending on various adjustments necessitated by the Code as a whole? The Supreme Court showed its agreement with the latter by stating that "[t]he section does not imply in any way that the 'deduction' and the 'item' must necessarily be equal in amount."[32] The Court went on to emphasize the fact that § 1341 was placed in subchapter Q (which deals with the side effects of the annual accounting system) and therefore it was plain that a refer-

[32] Skelly Oil Co. v. United States, 394 U.S. 678, 683 (1969).

ence to other sections of the Code was necessary to determine the amount of the deduction.[33] The Treasury Regulations seem to substantiate this view since it specifically refers to the deduction as arising under the provisions of chapter 1.[34]

Thus, the Court in *Skelly* interpreted § 1341 as requiring that some sort of deduction be allowed as a result of the refund in income, but it did not necessarily equate that deduction with the amount of the item included in the prior year's gross income.

As pointed out above, § 1341 sets up three conditions to be met before it can be applied, *i.e.*, *if* an item and *if* a deduction and *if* over $3,000 then. . . . It does not state that the taxpayer is entitled to a deduction in the amount of the item. Section 1341 did not create a new deduction to be measured by the amount of the returned item. As the legislative history shows, its sole purpose was to relieve the inequities caused by taking the already permissible deduction in a year where the tax rates were lower than in the year of receipt.[35]

On the other hand, while the statute on its face does not specifically equate the terms "item" and "deduction," a close analysis of the legislative history shows that Congress, nevertheless may have intended to equate them. The Congressional Committee Reports seem to be consonant with the interpretation that the item and deduction are equal.

> The Committee's bill provides that if the *amount restored* exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution [emphasis added.][36]

Note that the language used in § 1341 (a)(3) is as follows: ". . .the amount of such *deduction* exceeds $3,000 [emphasis added.]" Yet the Committee Report substitutes the words "amount restored," *i.e.*, the item, for the word "deduction." This seems to imply that Congress assumed that the item and the deduction were one and the same. Furthermore, it is clear from the Committee Reports that the words "item" and "amount"

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[33] *Id.*

[34] Treas. Reg. § 1.1341-1 (1957), which provides:

"If during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section."

[35] S. REP. NO. 1622, 83d Cong., 2d Sess. 118. H. REP. NO. 1337, 83d Cong., 2d Sess. 86 (1954).

"Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year."

[36] *Id.*

were used interchangeably by Congress.[37] This provides further evidence that the amount of the deduction and the item included in gross income were thought of as being equal.

B. The Need for Adjustments Under § 1341

While it is true that § 1341 does not, on the surface, specifically equate "item" and "deduction," it is also true that it does not specifically require the deduction to be adjusted by referring to other sections of the Code. However the Committee Reports do show an apparent intent to adjust an (a)(5) computation in some situations.[38] The same is true for the Treasury Regulations, which in addition specifically mention adjustments for depletion allowances.[39] However, it is significant that both of these sources refer only to an (a)(5) computation, and that nowhere in the Committee Reports or the Treasury Regulations is there any mention of any type of adjustment to be made in an (a)(4) computation.

The question then arises as to why Congress would require an (a)(5) computation to be adjusted, and at the same time, conspicuously neglect to require adjustments for an (a)(4) computation. On the one hand, it can be argued that the adjustments in the Treasury Regulations on (a)(5) should be viewed as encompassing the entire section as a whole including (a)(4). However, it has been suggested that the Treasury Regulations are invalid on the subject of depletion adjustments.[40] Both the Committee Reports and the Treasury Regulations speak about income dependent upon adjusted gross income and taxable income. Depletion allowances, however, are not a function of adjusted gross income, but rather are based upon "gross income from the property."[41] Thus, the validity of the Regulation on the subject of depletion adjustments is highly questionable, especially in view of the fact that § 1341 (a)(5)(B) states very clearly that the tax

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[37] *See* note 33.

[38] S. REP. NO. 1622, 83d Cong., 2d Sess. 118, 452 (1954):
"In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected."

[39] Treas. Reg. § 1.1341-1 (d)(4) (ii) (1954), which provides:
"No item other than the exclusion of the income proviously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax."

[40] *See generally*, Casey and Craig, *Restoration of Claim of Right Income and Percentage Depletion*, 68 DICK. L. REV. 381 (1963).

[41] *See* note 3 *supra*.

for the prior year is computed ". . .*solely* from the exclusion of such item from gross income. . . ." [emphasis added]. The use of the unequivocable word "solely" seems to preclude a reference to either the legislative history or the Treasury Regulations on the possibility of adjustments.

Even if it is assumed, however, that the Treasury Regulation is valid on this point, and that the word "solely" does not preclude a reference to it, the theory that it was intended to encompass the entire section as a whole cannot be supported. The Committee Reports do not show this intent. The adjustments are limited exclusively to situations where "[t]he tax reduction for the prior taxable year. . . ."[42] is being computed ((a)(5) computation).

It should be recalled at this point that (a)(4) is the applicable alternative in the noted case and that it represents merely the codification of the case law prior to the enactment of § 1341. Viewed in that light, the absence of adjustments under (a)(4) is not surprising. If any adjustments are to be made under (a)(4) the justification for them must be found in the pre-§1341 case law. The Supreme Court in the *Lewis* and *Healy* cases absolutely prohibited any adjustments, and it was for this reason that (a)(5) had to be formulated. Thus, Congress had good reason to allow various adjustments under an (a)(5) computation and to preclude them under (a)(4). It should be recalled again that (a)(5) utilizes a modified transactional approach in that it does refer back to the prior year's tax, and it therefore logically follows that it should permit adjustments of that tax via the Treasury Regulations. An (a)(4) computation, however, because of its origin, is required to utilize the strict annual approach, and under that method the prior year's tax cannot be recomputed or adjusted in any way.

The use of the words "gross income" in (a)(1) also seems to further substantiate the argument that the adjustment for depletion allowances be prohibited. Gross income has been defined in the Treasury Regulations as follows:

> [T]he total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined *without subtraction of depletion allowances* based on a percentage of income . . . [emphasis added.][43]

Section 1341 requires that the item be included in gross income, and the amounts refunded by Skelly in the noted case, both the taxable amount and the depletion allowance, were included in the previous year's gross income. Any type of adjustment concerning a depletion allowance would seem to be expressly prohibited by the use of this terminology. Section

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[42] *See* note 38 *supra.*

[43] Treas. Reg. § 1.61-3(a) (1957).

1341 (a)(1) requires only that the item be included in gross income. It does not say taxable income, nor does it mention any adjustments.

C. The Possibility of a Double Deduction Under § 1341

The Supreme Court, however, held that the failure to compute such adjustments would allow Skelly " '[t]he practical equivalent of a double deduction'. . . ."[44] which is impermissible without a clear declaration of intent by Congress.[45] The purpose of § 1341 was to correct the inequities created by *Healy* and *Lewis*, not to create a windfall in the form of a double deduction. Skelly took a 27½% depletion deduction in the years of receipt and has now taken a 100% deduction on the amount returned, including the amount of the depletion allowance. The Supreme Court held that since the deduction mentioned in § 1341 (a)(2) did not necessarily mean the same amount of the item included in gross income, a reference to the Code as a whole was necessary. Thus, a referral to § 1016 (a)(2), which deals with "Adjustments to Basis," reveals that: "(a) proper adjustment in respect of the property shall in all cases be made . . .(a) . . . for exhaustion, wear and tear, obsolescence, amortization and *depletion* . . . [emphasis added.]" And in the Treasury Regulations under § 1.1016-6(a) we find that "[a]djustments must always be made to eliminate double deductions or their equivalent." In fact § 1341 itself contains an express provision against taking double deductions as stated in § 1341 (b)(3):

> If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(5), then the deduction referred to in subsection (a)(2) shall not be taken into account for any purpose of this subtitle other than this section.

Again however, the above statement contained in (b)(3) only applies to an (a)(5) computation, and this is an (a)(4) situation. The conspicuous absence of such a statement pertaining to (a)(4) is significant in that it further illustrates the vast differences between the two alternatives. It is not altogether inconceivable that Congress might well have intended even to allow double deductions under (a)(4) in order to perserve the sanctity of the accounting system, especially in view of their apparent intent to equate the words "item" and "deduction."

In spite of this possibility however, the question in the noted case does not center around whether a double deduction should be permitted in these circumstances, but rather whether there actually was a double deduction involved. Justice Stewart, in his dissenting opinion points out that

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44 Skelly Oil Co. v. United States, 394 U.S. 678, 684 (1969).

45 Ilfeld v. Hernandez, 292 U.S. 62, 68 (1934):
"If allowed, this would be the practical equivalent of a double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers."

in all cases involving true double deductions, the taxpayer tried to deduct twice for the same item. He states further:

> In this case, by contrast, the respondent has taken two different deductions accorded by Congress for distinct purposes. In the years 1952 through 1957 it deducted the proper amounts for depletion—a deduction which is allowed by Congress "on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit," and which is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired . . . ." The respondent's 1958 deduction was granted by Congress for the entirely different reason that the refund of previously reported income constituted a loss, or business expense. In purpose and effect the deductions are wholly unrelated, and each is sustainable on its own merits. Certainly it cannot be said either that the respondent did not in fact exhaust the capital assets for which the deductions were allowed in 1952 through 1957 or that it did not suffer a business loss by the 1958 repayment.[46]

D. *Congressional Intent*

One of the major focal points in the case centers around the real intent of Congress in enacting § 1341, and the related question of what it did not intend. The majority was of the opinion that Congress could not have intended the absurd result argued by Skelly. The Court points out that under the old law which (a)(4) codifies, either the Government or the taxpayer might be the beneficiary, depending upon the circumstances. Thus, if tax rates had declined since the year of receipt, then the Government benefited under the old law, but if they had increased, the taxpayer benefited. But as the Court states towards the end of the opinion, "[h]ere, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result."[47] Furthermore, the purpose of a tax is to collect revenue, and the effect of giving the taxpayer back $1.275 for every $1.00 paid certainly does not achieve that goal. The motivating force behind § 1341 was a desire to compensate the taxpayer, not to provide him with an unexpected windfall.

One might ask, however, why the Court did not make such statements in *Lewis* and *Healy* concerning the "inequitable result" achieved. What consolation was it to the individual taxpayers in those cases when they were told that the Government might lose in another set of circumstances. In fact, Congress was fully aware of this false consolation when it enacted § 1341, and it was, in essence, the reason for enacting it. The Supreme Court incorrectly assumes that since Skelly chose to utilize the (a)(4) com-

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[46] Skelly Oil Co. v. United States, 394 U.S. 678, 695-96 (1969).

[47] *Id.* at 686.

putation, § 1341 can be completely ignored since (a)(4) represents merely the codification of the old case law. After making this assumption, the Court concludes that since, under the old law, there were cases in which the Government benefitted, (a)(4) cannot stand for the proposition that the taxpayer always wins. This obviously carries the case law codification a bit too far, and in effect, cancels out the very reason for enacting § 1341. Congress provided, and in fact required, that the taxpayer utilize the computation that produced the lesser tax. With that in mind, it is readily apparent that (a)(4) would *never* be used in a situation where the Government would benefit because the alternate computation under (a)(5) would always compensate the taxpayer fully and, therefore, be the lesser tax. The only time (a)(4) would be used by the taxpayer would be in a situation where his tax rate or bracket has not changed, or where the tax rate has increased since the year of receipt. As was pointed out above, the latter situation allows the taxpayer to receive a deduction benefit in an amount which *exceeds* the tax detriment in the year of receipt. The conclusion obviously then is that Congress did indeed intend, and in fact required, that the taxpayer always win and the Government always lose under § 1341.

IV. Arguments Based on Pre-§ 1341 Case Law

Up to this point major emphasis has been placed on the interpretation of the statute itself, thus illustrating the various ambiguities and questions presented by its terminology. However, there is one basic point upon which the Supreme Count, the Government, and Skelly Oil Co. all concur—namely, that § 1341 (a)(4) codified the old case law as expressed in *Healy* and *Lewis.* It therefore seems logical that the search for the definition of the term "deduction," and the possibility of required adjustments, be conducted primarily in the area of the old case law. Once all parties agree that (a)(4) codified pre-§ 1341 law, it seems rather fruitless to argue about what the word "deduction" means in the statute when the answer can easily be found by discovering how the courts defined it before § 1341 was enacted. The Court should have by-passed the ambiguities of the statute and looked more closely at the specifics of the case law.

A. Definition of Deduction Under Old Case Law

First, it should be recalled that the deduction itself was first mentioned in the case of *North American Oil Consolidated v. Burnet,* which demanded that the deduction be taken in the year of return in order to preserve the accounting year. Although the Court in that case did not define what the deduction would be, it was determined by all the courts following that decision that it would be the amount of the item included in gross income during the year of receipt.[48] Thus, in the *Healy* case the Supreme Court states:

> The Government concedes that each of these taxpayers is entitled to a deduction for a loss in the year of repayment *of the amount earlier included in income* [emphasis added.][49]

Furthermore, the Committee Reports show that Congress expressly intended to codify the Lewis case as representative of the old law to be used in (a)(4).[50] It would be logical to assume that Congress therefore intended that the definition of the word "deduction" be found in that case. *Lewis* clearly states[51] that the amount of the deduction is the equivalent of the amount of the item included in the previous year's gross income.[52]

The case law therefore seems to substantiate Skelly's argument in the noted case. However, there is one instance in the old cases that closely resembles the situation in Skelly. The case of *O'Meara v. Commissioner*[53] held in 1947 that the taxpayer had to adjust his deduction to reflect a previously taken depletion allowance. It should be noted however, that this was a Tax Court case and it was never reviewed by a higher court. The situation is also distinguishable on its facts in that the taxpayer never held title to the oil producing land and, therefore, was never entitled to a depletion allowance in the first place.

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[48] 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.106a at 431 (rev. ed. 1967). "However, under prior law the taxpayer was entitled only to a deduction in the later year of the amount repaid or restored in that year. (Citing Fleet Carrier Corp. v. Commissioner, 37 T.C. 527 (1961); Estate of Samuel Stein 37 T.C. 945 (1962), subsequent proceedings 40 T.C. 275 (1963).)"

[49] 345 U.S. at 284.

[50] H. REP. NO. 1337, 83d Cong., 2d Sess. A294, A295. S. REP. NO. 1622, 83d Cong., 2d Sess. 451 (1954).

"If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled a deduction only in the year of repayment."

[51] 340 U.S. at 591.

"[T]he Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return."

[52] Note that both Healy and Lewis refer to G.C.M. 16730, XV-1 CUM. BULL. 179, 181 (1936). That Bulletin states:

"On authority of the cases cited herein, this office is of the opinion that the profits in question should not be eliminated from the taxpayer's gross income for the years 1928 and 1929, but that the taxpayer is entitled to a deduction, for the year in which paid, of the amount of the profits paid. . . ."

[53] 8 T.C. 622 (1947).

B. *The Need for Adjustments Under the Old Case Law*

There is also a pre-§ 1341 case suggesting that a reference to the prior year's tax is permissible in certain circumstances. In the case of *Arrowsmith v. Commissioner*,[54] the Supreme Court ruled that an examination of the prior year's tax returns was necessary to determine whether the current year repayment gave the taxpayer a right to an ordinary or capital loss. The taxpayer in that case had attempted to take a full 100% regular loss on refunded income that had been received as a capital gain and had therefore been taxed at a lower rate. The Court in *Skelly* felt that the same situation presented itself here and concluded that "[i]f money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income."[55] Thus, *Arrowsmith* stands for the proposition that the circumstances surrounding the receipt of claim of right income cannot be ignored and must be taken into account when the taxpayer claims a deduction in the year of repayment. In short the Court states that "[t]he annual accounting concept does not require us to close our eyes to what happened in prior years."[56] Again one wonders why this statement did not find its way into the opinions of the *Healy* and *Lewis* cases.

V. Conclusion

Having explored all of the arguments put forth by the Government, Skelly Oil and the Court, it becomes necessary to make a more detailed analysis of the Court's opinion to discover exactly which argument they actually relied on in reaching their decision. First, it seems safe to assume that the holding was not based on the theory that the spirit of (a)(5) was intended to embrace § 1341 as a whole (including the Treasury Regulations). Despite the fact that *Skelly* gives us a modified transactional result, the Court expressly retained the *Healy* case,[57] and to say that (a)(5) encompasses (a)(4) would, in effect, overrule *Healy* since (a)(4) and (a)(5) are entirely opposite approaches.

Nor is the holding based on an interpretation of § 1341 as saying that the deduction must be computed with reference to the Code as a whole.

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54 344 U.S. 6 (1952).

55 Skelly Oil Co. v. United States, 394 U.S. 678, 685 (1969).

56 *Id.* at 684.

57 *Id.*

"In cases arising under the claim of right doctrine, this emphasis on the annual accounting period normally requires that the tax consequences of a receipt should not determine the size of the deduction allowable in the year of repayment. There is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year. *See* Healy v. Commissioner. . . ."

The Court was aware of the fact that the definition of the word "deduction" had to be found in the pre-§ 1341 case law since (a)(4) merely codified it. Justice Marshall recognized this when he stated:

> When the new approach was not advantageous to the taxpayer, *the old law was to apply* under § 1341 (a)(4).
>
> . . . Accordingly, as the courts below recognized, respondent's taxes must be computed under § 1341 (a)(4) and thus, in effect, *without regard to the special relief Congress provided through the enactment of § 1341* [emphasis added].[58]

Furthermore, the result in *Skelly* does not seem to be based on *O'Meara v. Commissioner*. While it is true that *O'Meara* must be considered as part of the common law definition of the word "deduction," it is also true that this case carries very little weight since it had never been reviewed by a higher court. Obviously, the validity of the decision is not affected by the absence of appellate review, but its influence on the Supreme Court is significantly reduced. This is especially true when the decision seems to be a mere statement of a new principle without any reasoning to support it. The majority in *Skelly* appears to have been cognizant of this fact and, consequently, only refers to the case in passing. It is submitted that the Court in Skelly was merely attempting to justify the *O'Meara* case—they were not relying upon it.

The majority opinion attempts to justify its position that the situation in *Skelly* gives rise to an *Arrowsmith* type exception to the *Lewis* case. The Court emphasizes that tax rates and brackets are still ignored just as they were in *Arrowsmith*,[59] and, consequently, neither case is in direct conflict with Lewis. Furthermore, the Court gives the circumstances here an appearance of exceptionalism by pointing out that "[t]he approach here will affect only a few cases."[60] The Court also claims that "[h]ere as in Arrowsmith the earlier returns are not being reopened.",[61] but rather a current year deduction is being computed in light of the circumstances surrounding the receipt of the claim of right income. It is submitted that while this argument may be valid in *Arrowsmith*, it has no application in the noted case. In *Skelly*, the Court has allowed a *recomputation*, based on the prior year's tax record, to discover *how much* excess depletion allowances were given in the prior year. In *Arrowsmith*, on the other hand, there was no recomputation involved, but merely a *glance* at the prior year's tax record to see *what kind* (not how much) of a loss (ordinary or capital) was involved. In other words, *Arrowsmith* permits a recog-

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[58] 394 U.S. at 682.

[59] *Id.* at 685.

"No attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts of prior years."

[60] *Id.* at 686.

[61] *Id.* at 685.

nition, but not a recomputation. As was emphasized above, any type of recomputation is contrary to *Healy* and *Lewis*, even though the adjustment is reflected in the current year. If *Arrowsmith* allows a recomputation in the current year because of the depletion allowance in the prior year, what would preclude *Arrowsmith* from allowing a current year recomputation because of higher tax rates in the prior year? More precisely, if *Arrowsmith* stands for the proposition that the circumstances surrounding the receipt of claim of right income must be taken into account in the form of an adjustment when the taxpayer claims a deduction in the year of repayment, how can it be argued that the tax rate is not just as much a "circumstance" as a depletion allowance. It should be clear, therefore, that such an interpretation of *Arrowsmith* would overrule *Healy* and *Lewis*, since it would permit the very type of recomputation prohibited in those cases. Furthermore, such an interpretation would eliminate the need for (a)(5). Obviously Congress did not read *Arrowsmith* that way and neither has the Supreme Court in *Skelly* since, as was pointed out above, the opinion specifically retains the *Healy* case.

Finally, it is submitted that the decision in *Skelly* seems to be based on the double deduction theory, despite the arguments put forth by Justice Stewart in his dissent, *supra*. It is in this respect that *Arrowsmith* is important to the majority, in that it allows the Court to *look* back at the circumstances surrounding the receipt of the income and to recognize that it gives rise to a double deduction in the year of repayment. However, if the case is based on this theory it may create significant problems in the future in that it may require individual taxpayers who took a full medical or charitable deduction in the year of receipt, to take those deductions into account when they seek a deduction under (a)(4) in the year of repayment.[62] Justice Stewart recognizes that "[o]therwise there will be precisely the same kind of so-called 'double deduction' as the Court finds in this case."[63] It is also important to note that these minor adjustments will not be limited to cases involving more than $3,000 since the case is based on (a)(4), *i.e.*, the old law, which has no minimum requirement.[64] Even (a)(5) reflects Congress' recognition of the need to limit adjustments and recomputations to larger amounts so as not to put an overwhelming burden on the annual accounting concept. However, even if these adjustments were to be limited to larger amounts they would still be in direct contradiction to *Healy* and *Lewis* by allowing a recomputation based on the prior year's tax record. The Court in *Skelly* has also set the amount of the item to be deducted at taxable income, while the case law clearly shows that the item need only be included in gross income.

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[62] *See generally*, Stewart's dissent, pp. 692-699.

[63] *Id.* at 697.

[64] *See* note 30 *supra*.

In conclusion, it is submitted that the result in the noted case, despite the apparent superiority of Skelly's argument, was a desirable and equitable one in these circumstances. The Court showed its awareness of the difficulty of justifying the decision in the light of *Healy* and *Lewis* by effectively avoiding the problem. This is shown by the Court's presentation of the statutory argument which, in the final analysis, is actually irrelevant. This awareness is also illustrated by the Court's ultimate reliance on the double deduction argument which has no relevance to the *Healy* and *Lewis* problem. The Court could have more palatably, though incorrectly, relied on *Arrowsmith* by first reaffirming the validity of *Healy* and *Lewis*, and then holding that the circumstances in *Skelly* gave rise to an *Arrowsmith*-type exception. In this manner, the Court would be saying that *Arrowsmith* did not overrule *Healy* and *Lewis* and that, therefore, the tax rates would still be a circumstance to be ignored, while a depletion allowance would be a circumstance which had to be recognized as an exception. This, of course, would merely be an arbitrary extension of *Arrowsmith*, (by transforming a recognition into a recomputation) followed by an illogical limitation on that extension by stating that a recomputation is permissible for a depletion allowance, but not for tax rates. Furthermore, is is obviously contradictory to say that *Healy* and *Lewis* are still valid, but a recomputation is permissible. But no matter how arbitrary, illogical or contradictory that theory might be, it still would have been best to rely on it since it achieves the desired result by the creation of an arbitrary, but equitable exception. This exception would thus appear to be directly justified by Arrowsmith, but in fact, would only be indirectly justified by it, *i.e.*, *Arrowsmith* stands for the proposition that some exceptions are allowed. *Skelly* would then be, not an extension of *Arrowsmith*, but rather another exception in addition to *Arrowsmith*.

The Court seems to have stated this theory in the opinion, but effectively abandoned it by continuing on (because of its flaws, and out of a desire to justify this exception on other grounds) to put major reliance on the double deduction argument. In view of the possible complications which may arise out of that reliance, it is suggested that the Court should have ignored the insufficiency of the *Arrowsmith* argument, and omitted its discussion about double deductions. In that manner, the Court would have been indirectly saying that *Skelly* was a necessary and desirable exception to *Healy* and *Lewis*, thus eliminating the problem at hand without creating the new problem which it will undoubtedly have to face in the future.

James J. Erb